
INTRODUCTORY SECTION

STATE OF MAINE
DEPARTMENT OF ADMINISTRATIVE AND FINANCIAL SERVICES
OFFICE OF THE STATE CONTROLLER
14 STATE HOUSE STATION AUGUSTA, ME 04333-0014

EDWARD A. KARASS
STATE CONTROLLER



TERRY E. BRANN, CPA
DEPUTY STATE CONTROLLER

June 1, 2004

**To the Honorable John Elias Baldacci, Governor,
the Honorable Members of the Legislature, and
Citizens of the State of Maine**

We are pleased to present the State of Maine's Fiscal Year 2003 (FY2003) Comprehensive Annual Financial Report (CAFR) prepared in accordance with Generally Accepted Accounting Principles (GAAP). This report represents the second CAFR prepared in accordance with Governmental Accounting Standards Board (GASB) Statement 34. The annual CAFR, required by Title 5 M.R.S.A., §1547 is compiled and published by the Office of the State Controller (OSC). The report is the primary means of reporting the State's financial activities. The objective of this report is to provide a clear picture of our government as a single, unified entity, as well as providing traditional fund based financial statements.

Responsibility

The OSC is responsible for the accuracy, fairness and completeness of the financial statements presented in this report. The statements have been prepared in accordance with GAAP. To the best of our knowledge and belief, the information presented is accurate in all material respects and includes all disclosures necessary to enable the reader to gain a reasonable understanding of Maine's financial position and activities.

Adherence to Generally Accepted Accounting Principles

As required by State statute, we have prepared the CAFR in accordance with GAAP applicable to State and local governments, as promulgated by the GASB. The State also voluntarily follows the recommendations of the Government Finance Officers Association of the United States and Canada (GFOA) for the contents of government financial reports.

Format of Report

This CAFR is presented in three sections: Introductory, Financial and Statistical. The Introductory Section contains this letter including an overview of current initiatives, the list of principal elected and appointed officials, and the State government organization chart. The Financial Section contains: the independent auditor's report on the Basic Financial Statements; Management's Discussion and Analysis (MD&A), which provides an introduction, overview and analysis of the Basic Financial Statements; the Basic Financial Statements, which present the government-wide financial statements and fund financial statements for governmental funds, proprietary funds, fiduciary funds and similar component units, and component units, together with notes to the financial statements; Required Supplementary Information other than MD&A, which presents budgetary comparison schedules, schedules of pension funding progress, and information about infrastructure assets; and the supplemental financial data, which includes the combining financial statements and schedules.

This letter of transmittal is designed to complement MD&A where the financial analysis is now presented. The State's MD&A can be found immediately following the independent auditor's report from the State Auditor. The Statistical Section contains selected trend information, and statistical data on financial, economic and demographic measures.

Internal Control Structure

The Office of the Controller prepares these financial statements and assumes full responsibility for the completeness and reliability of the information presented in this report. To provide a reasonable basis for making these representations, the Office of the Controller has established a comprehensive internal control framework that is designed to protect the State's assets from loss, theft, or misuse and to compile sufficient reliable information for the preparation of the State of Maine's financial statements in conformity with GAAP.

Because the cost of internal controls should not outweigh their benefits, the State's comprehensive framework of internal controls has been designed to provide reasonable rather than absolute assurance that the financial statements will be free from material misstatement.

As a recipient of federal financial assistance for federal programs, the State is also responsible for ensuring that an adequate internal control structure is in place to ensure and document compliance with applicable laws and regulations related to these federal programs. The internal control structure is subject to periodic evaluation by management and by the State Department of Audit as part of the annual Single Audit.

Independent Auditors

Pursuant to Title 5 M.R.S.A. § 243, the State Auditor has performed an examination of the Basic Financial Statements in accordance with auditing standards generally accepted in the United States of America. The auditor's opinion is presented in the financial section of this report. The audit involved examining, on a test basis, evidence supporting the amounts and disclosures in the Basic Financial Statements; assessing the accounting principles used and significant estimates made by management; and, evaluating the overall financial statement presentation. The State Auditor rendered an unqualified opinion on the Basic Financial Statements for this fiscal year.

Also, pursuant to § 243 the State Auditor has undertaken a Single Audit of the State as a whole, in accordance with auditing standards generally accepted in the United States of America and the standards applicable to financial audits contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, as required by federal law. The standards governing Single Audit engagements require the auditor to report not only on the fair presentation of the financial statements, but also on the government's internal controls and compliance with legal requirements involving the administration of federal awards. This statewide federal Single Audit Report, including the auditor's opinion in accordance with generally accepted auditing standards, is published separately.

We express our appreciation to the staff of the State Auditor for their professionalism. The State Auditor is statutorily mandated to audit all accounts and other financial records of State Government or any department or agency of State Government, including the judiciary and the Executive Department of the Governor, except the Governor's Expense Account, and to report annually, and at such other times as the Legislature may require.

Management's Discussion and Analysis (MD&A)

GASB Statement No. 34 requires that management provide a narrative introduction, overview and analysis to accompany the Basic Financial Statements in the form of MD&A. This letter of transmittal is designed to complement the MD&A and should be read in conjunction with it.

PROFILE OF THE GOVERNMENT

Reporting Entity

The Governor and Legislature govern all funds and accounts for every executive agency, board, commission, public trust, Authority and component unit. The State of Maine financial reporting entity reflected in the CAFR, which is more fully described in Note 2 to the Basic Financial Statements, includes these funds, agencies, organizations, boards, commissions, Authorities and major component units in accordance with GASB Statement 14. There are 11 major component units, two blended component units, and one fiduciary component unit included in the CAFR. The major component units are discretely presented in the financial statements; and the blended component units are included as separate funds in the fund financial statements. The fiduciary component unit is presented in the fiduciary fund and similar component unit financial statements along with the other fiduciary activities of the State. The fiduciary activities are not included in the government-wide financial statements because the resources of these funds are not available to support the State's own programs.

The departments of the primary government record their daily financial operations in the State accounting system called the Maine Financial and Administrative Statewide Information System (MFASIS) operated by the Office of the State Controller.

Budgetary Control

The Governor presents a biennial budget for the General Fund and the Special Revenue Funds to the Legislature for enactment or revision. The State Constitution provides the Governor a "line item" veto, which allows an Executive dollar substitution for those amounts disapproved, as long as an appropriation or allocation is not increased (or a deappropriation or deallocation decreased) either in the specified line or in any other line in the legislative document.

Once passed and signed, the budget becomes the financial plan for the State for the next biennium. It includes proposed expenditures for all departments and agencies, interest and debt redemption charges, and expenditures for capital projects to be undertaken and executed during each fiscal year. The budget also includes anticipated revenues and any other means of financing expenditures. In accordance with statute, the State Budget Officer must use the projections of the Revenue Forecasting Committee to prepare the General Fund and Highway Fund budgets.

The total General Fund appropriation for each fiscal year of the biennium in the Governor's budget submission to the Legislature may not exceed the General Fund appropriation of the previous fiscal year multiplied by one plus the average real personal income growth rate, as defined in Title 5 M.R.S.A. § 1665, subsection 1, plus the average forecasted inflation rate. "Average forecasted inflation rate" means the average forecasted change in the Consumer Price Index underlying the revenue projections developed by the Revenue Forecasting Committee. This appropriation limitation may be exceeded only by the amount of the additional costs or the lost federal revenue from the following exceptional circumstances: unfunded or under-funded new federal mandates; losses in federal revenues or other revenue sources; citizens' initiatives or referenda that require increased State spending; court orders or decrees that require additional State resources to comply with the orders or decrees; and sudden or significant increases in demand for existing State services that are not the result of legislative changes that increased eligibility or increased benefits. The Governor may designate exceptional circumstances that are not explicitly defined, but meet the intent of, this statute. "Exceptional circumstances" means an unforeseen condition or conditions over which the Governor and the Legislature have little or no control. Exceptional circumstances do not apply to new programs or program expansions that go beyond existing program criteria and operation.

The State maintains budgetary control at the account and line category levels. The head of each department and agency of State government must submit a work program to the Bureau of the Budget for the ensuing fiscal year. The work program is classified to show allotments requested for specific amounts for personal services, capital expenditures, and all other departmental expenses. These are the levels at which appropriations and allocations are approved by the Legislature, principally through a quarterly allotment system. The State Controller authorizes all expenditures to be made from the amounts available on the basis of these allotments and not otherwise.

Budget revisions during the year, reflecting program changes or intradepartmental administrative transfers, require the approval of the State Budget Officer and the Governor. Except in specific instances, only the Legislature may transfer appropriations between departments. Agency requests for increases in appropriations, allocations, or funding for new programs are presented to the Legislature as a supplemental budget.

The State uses encumbrance accounting as an extension of formal budgetary control. This requires that purchase orders, contracts, and other commitments be recorded to reserve a portion of an appropriation or allocation for expenditure. Appropriated and allocated balances are available for subsequent expenditure to the extent that there are approved encumbrances at the end of a fiscal year. The State reports encumbrances outstanding at year-end as reservations of fund balances to identify those portions of fund balances that are not available for allocation or expenditure, or that are legally segregated for specific future uses. Unencumbered appropriations in the General Fund and in the Highway Fund are carried forward to a subsequent year only when authorized by law, otherwise the balances lapse at year-end.

Maine Budget Stabilization Fund

The Maine Budget Stabilization Fund, established in 2003 in Chapter 451, Public Laws 2003 to replace the Maine Rainy Day Fund, is a General Fund reserve account intended to be used for the prepayment of outstanding General Fund bonds and for major construction (defined as a single project with a total cost of over \$500,000), and may also be used when revenues are under budget and critical services must be preserved. The Governor may also allocate funds from the Budget Stabilization Fund for payment of death benefits for law enforcement officers and firefighters.

Balances in the fund do not lapse; but carry forward each year. The money in the fund may be invested with any earnings credited to the fund except when the fund is at its statutory cap. In addition to interest earnings, the fund is capitalized at the close of each fiscal year. As the first priority before any other transfer, the State Controller is required to transfer 32% of the unappropriated surplus of the General Fund, when the fund is not at its statutory cap.

The statutory cap for the fund is 10% of the total General Fund revenue received in the immediately preceding fiscal year. At the close of the fiscal year, the cap is based on the revenue received in the fiscal year being closed. Based on fiscal year 2003 actual General Fund revenue, the statutory cap at the close of fiscal year 2003 and during fiscal year 2004 was \$239,469,019. At the close of fiscal year 2003, the balance of the Maine Budget Stabilization Fund was \$10,579,345. No reductions to the Maine Budget Stabilization Fund balance are required when it exceeds the balance of the statutory cap as a result of a decline of General Fund revenue.

ECONOMIC CONDITIONS AND OUTLOOK

The Maine economy appears to have stabilized. Following the past few years of robust economic growth, the State's employment actually declined 0.3% in 2002 and 0.2% in 2003. Meanwhile, as layoff announcements became more frequent, the State's jobless rate started to tick upward from its 2002 rate of 4.5% to 5.1% in 2003, but was still 0.9% below the national average of 6%. Income growth slowed 4.4% in 2002 to an estimated 4.1% for 2003. However, the good news is that economists are projecting a positive gain of 0.8% in employment during 2004.

It is interesting to note that even in our period of weakness, Maine's economic growth has, for the most part, outpaced that of both the nation and the region. National employment growth over the period was a negative 0.9% in 2002. With the nation experiencing deeper job cuts than Maine, unemployment spiked to 6%, a full 1.5 percentage points above the Pine Tree State. And for the first time in over a decade, Maine's income gains outpaced the nation's in 2001 and hit the national average in 2002.

The primary reason for Maine's relative "vibrancy" appears to be that our economy is far less invested in the technology sector which has been ravaged through the stock market adjustment, taking its toll on technology-dependent regions like New England and on the nation as a whole. In Maine, during 2003, taxable retail sales and construction contracts continued to improve. Construction contracts increased by 12.4% and taxable retail sales increased 4.6% over 2002.

Businesses invested \$146.3 million in Maine during 2003. Northern Maine saw the addition of 166 new jobs added to the economy in diverse industries that include manufacturing, computer services, and financial services. Central and Western Maine added 126 new jobs in various sectors and saw the investment of \$112.5 million by International Paper at their Jay facility. Southern Maine continued to grow economically as the Gulf of Maine Research Institute invested \$9.0 million and created 55 new jobs at the Portland Marine Research Center. Columbia Air Services retained 15 jobs and invested \$500,000 in their Trenton facility to provide aviation support services.

Maine's employment is expected to grow once more in 2004 at a rate of 0.8%. Most job gains will be in the non-manufacturing sector, led by retail trade, health and other services. Manufacturing employment is projected to continue its descent through the period, though the pace of decline will abate from -7% in 2003 to -3.2% in 2005. Further erosion in manufacturing employment will also constrain income gains through the period.

It appears that Maine was in a period of stabilization in 2003 and the trend will continue through part of 2004 until the US economy can develop enough traction to pull States out of their malaise. Overall, Maine's growth should resume in 2004 at a slow but steady gait.

CURRENT DEVELOPMENTS AND INITIATIVES

During 2003, the Governor proposed landmark legislation to create a health plan that will extend comprehensive health insurance to small employers, self-employed and the uninsured. Legislation was enacted in FY 2004 as a part of the plan establishing Dirigo Health. Dirigo Health is an independent State agency designed to implement the Governor's vision of health care reform in Maine.

FINANCIAL INFORMATION

Cash Management

The State pools cash for a variety of State agencies and public sector entities. Interest earned on pooled cash is allocated to the various funds, generally based on their average equity balances. In accordance with statute, the Treasurer of State may deposit State funds in any of the banking institutions organized under the laws of this State, and any national bank or federal savings and loan association located in the State. All State money in any depository of State Government shall be to the credit of the State but the Treasurer of State shall not withdraw any of the funds except upon the authority of the State Controller.

The Treasurer of State may invest funds that exceed current obligations, with the concurrence of the State Controller or the Commissioner of Administrative and Financial Services, and the consent of the Governor. The list of approved pool investments includes: U.S. Treasury Bills, Notes, Bonds and Agency Securities, certain secured repurchase agreements, prime commercial paper, tax-exempt obligations, banker's acceptances, and certain secured shares of an investment company registered under the federal Investment Company Act of 1940.

Deposits with financial institutions are classified by collateral risk into three categories. Category 1 is the amount of State deposits that are fully insured or collateralized with securities held by the State or its agent in the States name. Category 2 is the amount of deposits that are collateralized with securities held by the pledging financial institution's trust department or agent in the State's name. Category 3 is the amount of deposits that are neither collateralized nor insured. More detailed information about deposits can be found in the notes to the financial statements.

Debt Administration

When issuing General Obligation Bonds, the State of Maine pledges its full faith and credit to repay the financial obligation. Unless certain tax revenue streams are specifically restricted, states typically pledge all of their tax-raising powers to secure the obligations. The major bond rating agencies regularly assess the capacity and willingness of the State to repay its general obligation debt. Moody's Investors Service, Standard & Poor's, and FitchRatings make their assessments, in large part, by examining four basic analytical areas:

- Economy
- Financial Performance and Flexibility
- Debt Burden
- Administration

The economic base is the most critical element in determining the rating. Growth and diversity in the demographics, tax base, and employment base of the State over the last decade are indicators of future growth prospects and debt repayment capabilities. Generally, States with higher income levels and diverse economic bases have superior debt repayment capabilities and are better protected from sudden shocks or unexpected volatility in the economy. Because a strong economy does not always ensure a State's ability to meet debt payments, the State's financial management and performance are also key factors.

Financial analysis involves several factors, including: accounting and reporting methods; revenue and expenditure patterns; annual operating and budgetary performance; leverage and equity positions; budget and financial planning; and contingency obligations. These factors present a clear indication of the financial strengths and weaknesses of the State. The rating agencies' analyses of these factors provide the framework for judging Maine's capacity to manage economic, political, and financial uncertainties. Following is a history of Maine's credit ratings from three of the major rating agencies, and a brief explanation of their meanings:

Standard & Poor's

"AAA" is the highest Issuer Credit Rating assigned by Standard & Poor's. An obligor rated "AAA" has EXTREMELY strong capacity to meet its financial commitments. An obligor rated "AA" has VERY strong capacity to meet its financial commitments. It differs from the highest rated obligors only in small degree. Ratings from "AA" to "CCC" may be modified by the addition of a plus (+) or minus (-) sign to show relative standing within the major rating categories.

<u>Year</u>	<u>Rating</u>
1994	AA+
1995	AA+
1996	AA+
1997	AA+
1998	AA+
1999	AA+
2000	AA+
2001	AA+
2002	AA+
2003	AA+

Moody's Investors Service

Moody's is one of the few major rating agencies that measures total expected credit loss over the life of the security, assessing both the likelihood that the issuer will default and the amount of loss after a default occurs. "Aaa" rated bonds are judged to be of the best quality. Generally referred to as "gilt edge," they carry the smallest degree of risk. "Aa" rated bonds are judged to be of high quality by all standards and together with the "Aaa" group they comprise what is generally known as high grade bonds. Moody's applies one of three numerical modifiers to each generic rating classification from "Aa" to "Caa." The modifier 1 indicates that the issue ranks at the higher end of its generic rating category; the modifier 2 indicates a mid-range ranking; and the modifier 3 indicates that the issue ranks at the lower end of its generic category.

<u>Year</u>	<u>Rating</u>
1994	Aa
1995	Aa
1996	Aa
1997	Aa3*
1998	Aa2
1999	Aa2
2000	Aa2
2001	Aa2
2002	Aa2
2003	Aa2

** Refinement of Aa rating, not a downgrade*

FitchRatings

“AAA” indicates obligations that have the highest rating assigned by FitchRatings on its national rating scale. The capacity for timely repayment of principal and interest is considered extremely strong. “AA” indicates obligations for which capacity for timely repayment of principal and interest is very strong. Obligations rated “A” indicate that the capacity for timely repayment of principal and interest is strong relative to other obligors. However, adverse changes in business, economic or financial conditions are more likely to affect the capacity for timely repayment than for obligations in higher rated categories.

<u>Year</u>	<u>Rating</u>
1996	AA**
1997	AA
1998	AA
1999	AA
2000	AA+
2001	AA+
2002	Aa2
2003	Aa2

*** Initial rating in 1996, not
previously rated*

Various agencies and Authorities, the Maine Technical College System, and the University of Maine System issue revenue and/or lease-backed appropriation bonds. These obligations are supported solely by the revenues received by the issuing entities and the State is not obligated for such debt, nor is the full faith and credit of the State pledged for such debt. More detailed information about long-term obligations may be found in Note 11 to the financial statements.

Risk Management

In general, the State is “self-insured” for health and dental insurance, worker’s compensation, tort liability, vehicle liability, marine and aircraft, property losses, and retiree health insurance for State employees and teachers. The Risk Management Division’s activities include analysis of and control over insurance coverage and risk exposure. Risk Management funds the cost of providing claims servicing and claims payment by charging premiums to agencies based on a review of past losses and estimated losses for the current period.

OTHER INFORMATION

Acknowledgements and Conclusion

State government has many accomplishments of which it can be proud. Consistent with the vision of Governor Baldacci to improve and enhance the fiscal administration of governmental operations, the Office of the State Controller initiated the most far reaching reorganization of the Office and refocusing of its mission in modern times. The goal of the reorganization is to improve the skills and analytical capacity of the Office to better serve State agencies, the Governor, the Legislature, and the citizens of the State of Maine; bolster the professionalism of the State’s accountants; improve statewide internal controls over financial operations; and to adopt a code of ethics that will help to ensure accountability to the citizens of Maine. We must maintain this standard to maintain the public trust. We strike this balance between efficiency and integrity of operations through a system of internal controls. We strive to find solutions to many of the State’s financial challenges by partnering with financial and program managers, so that full input is heard.

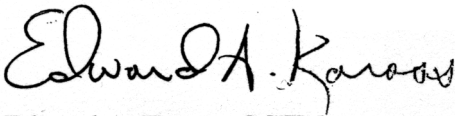
An agency CFO from Massachusetts recently described the budgetary challenges of this fiscal year facing State governments across the nation as the “perfect storm.”

- The pressures on revenues and the demand by citizens to maintain critical services are reducing staff availability throughout State government;
- Fiscal officers and their departments are being challenged with far reaching reorganization efforts in order to maintain critical services and fiscal control over operations; and,
- Once again, in the FY 2006-2007 we be called upon to meet the challenges presented by limited resources and demands for services by our citizens.

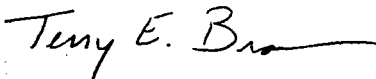
In an environment where economic resources are limited and agencies are coping with budget constraints, the challenge of maintaining effective internal controls is greater than ever. We will continue to partner with each department, at its highest levels, to ensure that the tools are available to help each agency assess its risks and target controls to manage those risks effectively and within its budgetary constraints whenever possible.

Each year the preparation of the CAFR requires the efforts of the finance people throughout the State, from virtually all agencies, departments and component units. We sincerely appreciate the dedicated efforts of all of these individuals. I wish to express my appreciation to the Department of Audit for their help and cooperation. I am especially proud of the dedication and contributions of the staff of the Office of the State Controller, who each day makes a contribution to maintaining the public's trust in our financial operations. Their efforts culminate in the CAFR each year, and for the second year running have achieved an unqualified opinion from our auditors.

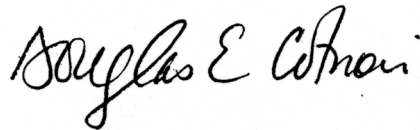
Sincerely,



Edward A. Karass, CGFM
State Controller



Terry E. Brann, CPA
Deputy State Controller



Douglas E. Cotnoir, CPA CIA
Manager, Financial Reporting & Analysis



STATE OF MAINE

OFFICIALS OF STATE GOVERNMENT

AS OF JUNE 30, 2003

EXECUTIVE

John Elias Baldacci, *Governor*

LEGISLATIVE

Beverly C. Daggett, *President of the Senate*

Patrick Colwell, *Speaker of the House*

Constitutional/Statutory Officers

G. Steven Rowe, *Attorney General*

Gail M. Chase, *State Auditor*

Dan A. Gwadowsky, *Secretary of State*

Dale McCormick, *State Treasurer*

JUDICIAL

Leigh Ingalls Saufley, *Chief Justice of the State Supreme Court*

ORGANIZATION CHART OF MAINE STATE GOVERNMENT AS OF JUNE 30, 2003

